

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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subject: Various questions concerning how to collect and apply restitution payments

This responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1. When restitution is ordered payable to the Service in a criminal case, how should the Service apply restitution payments if the order does not specify the years to which the payments should be applied?
2. How is an order for restitution in a criminal tax case enforced and collected?
3. How should the Service apply proceeds from an administrative collection action for civil tax liabilities when criminal restitution has also been ordered to be paid to the Service for some, but not all, of the same years?
4. When restitution is ordered payable to the Service in a criminal tax case for years for which the civil tax liabilities have not yet been determined and subsequent audit or reconsideration results in civil tax assessments that are lower than the amount of criminal restitution ordered, whether the Service can retain the excess funds or whether the government should move the court to amend the restitution order.

CONCLUSIONS

1. Restitution payments should be applied to the civil tax liabilities, including penalties and interest, for the year(s) involved in the criminal case. If an assessment for civil tax liabilities has not been made, the restitution payments should be held in the general fund until an assessment is made and then credited against the taxpayer's civil tax liabilities. When the restitution order does not specify how to apply payments, the Service has discretion to apply the payments to the applicable years in the order that best serves its interest.
2. The Service cannot take administrative collection action to collect the restitution ordered. The Department of Justice through its Financial Litigation Units is responsible for collection and enforcement of the restitution order. The Department of Justice may enforce a judgment imposing restitution in accordance with the practices and procedures for the enforcement of judgments under Federal and State law.
3. If the Service receives an undesignated voluntary payment or an involuntary payment for civil tax liabilities the Service may apply them in the order that best serves its interest. If some of the civil tax liabilities are for a year that was also involved in a criminal tax proceeding, the Service may decide that it is in its best interest to apply those payments first to the year(s) not involved in the criminal tax proceeding.
4. If the amount of the restitution has not been fully paid when the Service determines that the amount of the civil tax liabilities are less than the restitution, the government should notify the court and move that it make appropriate modifications to the order. If the restitution is fully paid, then the excess is an overpayment that can be applied against the taxpayer's other outstanding tax liabilities and any balance refunded, after a claim for refund is filed. If no claim for refund is filed within the applicable period of limitations, then the excess can be moved to the general fund.

FACTS

Oftentimes, a taxpayer will begin paying the restitution before an assessment is made. Sometimes the court does not specify in its order how the restitution payments should be applied. In addition, the taxpayer may have unpaid civil assessments for tax periods that were not part of the criminal case. For purposes of discussion, this section sets forth two sets of hypothetical facts. First, taxpayer A has assessments of civil tax liabilities for years 2000 through 2002. A was convicted in a criminal case for making false statements on income tax returns for tax years 2000 and 2001. Taxpayer B had civil tax liabilities for 2000 through 2004 and a Notice of Federal Tax Lien was recorded 1/2/2006. B was convicted in a criminal case for making false statements on income tax

returns for tax years 2004, 2005 and 2006. The Court entered an order 11/1/2008 for B to pay restitution to the Service.

LAW AND ANALYSIS

Restitution is a legal remedy that requires a defendant to pay money or render services to a victim to redress the victim's loss. Restitution may be ordered by a United States district court as an independent element of a criminal sentence, as a condition of probation or supervised released, or pursuant to a plea agreement. See 18 U.S.C. §§ 3556, 3663(a)(1)(A) & (a)(3), 3663A(a)(1), 3563(b)(2) & (d). It may be mandatory in some cases. 18 U.S.C. § 3663A(a)(1). The amount of restitution is generally determined to be the loss caused by the specific conduct that is the basis of the offense of conviction.

In criminal tax cases, the Service is considered to be the victim. See United States v. Helmsley, 941 F. 2d 71 (2^d Cir. 1991). Restitution payable to the Service is ideally equivalent to the defendant's unpaid civil tax liability. Accordingly, the Service applies restitution payments against a taxpayer's unpaid civil tax liability for the tax year(s) involved in the criminal case. See Morse v. Commissioner, 419 F.3d 829, 834 n. 4 (8th Cir. 2005), aff'g T.C. Memo. 2003-332; see also Helmsley, at 102 ("[W]e believe it is self-evident that any amount paid as restitution for taxes owed must be deducted from any judgment entered for unpaid taxes in ... a civil proceeding."). Restitution, however, is not a tax and the Service has no authority to assess restitution as a tax. See I.R.C. § 6213. The taxpayer's civil tax liability for a year is only established when the Service makes an assessment under section 6201. Generally, when a criminal tax investigation is underway, the Service suspends the audit of a taxpayer that would establish a civil income tax liability for the same tax period. Therefore, oftentimes, the taxpayer may begin paying restitution before an assessment has been made, unless the taxpayer executed a Form 870 during the criminal proceeding (e.g. as a condition of the plea agreement) allowing for immediate assessment of the tax.

Generally, the Judgment and Commitment Orders entered by the court require taxpayers to submit their restitution payments to the office of the clerk of the district court in the district in which they were sentenced. The clerk of the court is responsible for monitoring compliance with restitution orders. After the clerk of the court records and processes the payments, the court forwards the appropriate funds to the victims listed in the order, including the Service, if applicable. If the payment of restitution to the Service is a condition of probation, the Service may also be responsible for monitoring compliance. See IRM 5.1.5.13 - 18. If the taxpayer is not compliant, the Service should notify a U.S. Probation Officer, who in turn will notify the court. Id.

Issue #1: Application of Restitution Payments

If payments are received before an assessment has been made for the tax year(s) at issue in the criminal case, then the funds are held in the general fund. Once an assessment is made, the Service should move the appropriate funds from the general fund and apply them to the assessment(s) against the taxpayer, as discussed further below. Thus, the Service needs to track the receipt of restitution payments carefully to ensure their proper application both before and after assessment.

For any restitution payment(s) received (or applied) after an assessment has been made for the tax year(s) at issue in the criminal case, the funds should be credited against a taxpayer's unpaid civil tax liability for the tax year(s) involved in the criminal case. This is because the restitution was ordered to compensate the Service for losses associated with criminal conduct in those years only. For example, in the case of taxpayer A discussed in the facts section, the restitution was ordered with respect to 2000 and 2001, so payments must be applied to those years until those civil tax liabilities are satisfied or the taxpayer fully pays the amount ordered as restitution. If the order sets forth how much restitution the taxpayer owes per year at issue in the case, the Service must apply the payments accordingly.

The Service has discretion as to the order in which the restitution payments are applied to the applicable periods. Restitution payments are involuntary payments. See, e.g., In re Tecson, 291 B.R. 199, 200 - 201 (Bankr. M.D. Fla. 2003) (restitution payments, stemming from a tax fraud conviction, were involuntary). The definition of an involuntary payment was established in Amos v. Commissioner, 47 T.C. 65, 69 (1966). In Amos, the Tax Court stated that an involuntary payment means "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." Id. Restitution payments are involuntary because they are made pursuant to an order entered by a court and are intended to compensate the Service for a tax loss.

While voluntary payments of ordinary tax debts may be applied in the manner that the taxpayer designates, taxpayers cannot designate how the Service should apply involuntary payments. See Rev. Proc. 2002-26, 2002-1 C.B. 746; In re Tecson, 291 B.R. at 200; Amos, 47 T.C. at 69. The Service can apply the restitution payments in the same manner that it applies other involuntary payments. See, e.g., In re Tecson, 291 B.R. at 200 – 201. Involuntary payments (and undesignated voluntary payments) are typically applied to the periods in the order of priority that the Service determines will serve its best interest. See Id.; see also In the Matter of Avildsen Tools and Machine, Inc. v. United States, 794 F.2d 1248, 1251 – 1252 (7th Cir. 1986). Generally, such payments are applied to the oldest year(s) first because the period of limitations on collection for older years will usually expire first. If the amount applied to a tax period is less than the liability for the period, usually the amount will be applied to tax, penalty, and interest, in that order, until the amount is absorbed. Rev. Proc. 2002-26.

Taxpayers must make restitution payments in strict accordance with the restitution order so that their account with the clerk of the court will be properly adjusted to reflect the payment. If their accounts are not adjusted properly, they may be found not in compliance with the order. As taxpayers cannot make restitution payments directly to the Service, any payment received by the Service directly from the taxpayer will be applied towards the taxpayer's civil tax liabilities under the Service's normal procedures. Accordingly, if the taxpayer is eligible to designate the payment pursuant to Rev. Proc. 2002-26, they may so designate. The Service will apply any undesignated voluntary payments in the manner that best serves its interest. Rev. Proc. 2002-26, sec. 3.02.

Issue #2: Collection of Restitution Payments

The Department of Justice's Financial Litigation Units are responsible for collecting and enforcing amounts due under sentencing orders, including restitution orders. See, e.g., IRM 3.17.80.1.3. Courts have held that a restitution order is not in and of itself a civil judgment. See United States v. Mindel, 80 F.3d 394, 398 (9th Cir. 1996). The restitution order is separate from and in addition to any civil enforcement action the Service may wish to take. An order of restitution must be enforced in accordance with 18 U.S.C. § 3664. 18 U.S.C. § 3556. In addition, an order of restitution may be enforced by the United States in the manner provided for in 18 U.S.C. §§ 3571 – 3574 and 3611 - 3615, or by all other available and reasonable means. 18 U.S.C. § 3664(m). Thus, the United States may enforce a judgment imposing restitution in accordance with the practices and procedures for the enforcement of judgments under Federal and State law.

An order of restitution creates a lien in favor of the United States on all property and rights to property of the person fined as if the liability of the person fined were a liability for a tax assessed under the Code. 18 U.S.C. § 3613(c). As with civil tax liabilities, the United States may file a notice of lien to secure the liability. See 18 U.S.C. § 3613(d). The United States will release the lien after the restitution is paid in full.

As restitution is not a civil tax judgment, the Service cannot take administrative collection action until it makes an assessment for the civil tax liabilities. Once the tax assessment is made, it may take administrative tax collection action to pursue those civil tax liabilities, as it would collect any other civil tax liability. For tax years that were the subject of the criminal proceeding, the Service would not be enforcing the restitution order but rather its civil assessment of taxes for the periods involved in the criminal action.

Issue #3: Administrative Collection Action and Restitution

The Service may initiate collection action for civil tax liabilities due for years that may also have been involved in a criminal action for which restitution was ordered to be paid to the Service. Thus, the Service may receive restitution payments and proceeds from its collection action for the same year(s).

As discussed above, restitution payments must be applied to the years involved in the criminal proceeding. If the restitution order does not specify how to apply the payments to the years involved in the case, the Service can apply them in the order that best serves its interest. The same rules regarding voluntary and involuntary payments apply to proceeds of the Service's collection action. If the taxpayer makes voluntary payments, they may be able to designate the payments pursuant to Rev. Proc. 2002-26. If the taxpayer designates a voluntary payment, the Service should apply the payment as directed by the taxpayer. Undesignated voluntary payments and involuntary payments, such as levy proceeds, are applied at the Service's discretion. Proceeds from the Service's collection action should be applied to the liabilities underlying the collection action.

Because restitution payments are applied against the taxpayer's civil tax liabilities, the Service may decide that it is in its best interest to apply proceeds from its civil collection actions first to the year(s) that were not also involved in the criminal proceeding and then to the year(s) that were involved in the criminal proceeding. Similarly, if there are civil tax liabilities and restitution due for the same tax year but for different types of tax, the Service may decide that it is in its best interest to apply proceeds from its civil enforcement action against the tax liability not at issue in the criminal proceeding. See, e.g., Gnifkowski v. United States, 93 A.F.T.R.2d 2004-1159, 2004 WL 569534 (2004) (Service applied proceeds from a levy to non-trust fund recovery penalty tax liabilities for which restitution had been ordered in a criminal proceeding).

For example, consider taxpayer B from the facts section above. The Service assessed civil tax liabilities for 2000 through 2004 and a Notice of Federal Tax Lien was recorded 1/2/2006. B was convicted in a criminal case for making false statements on income tax returns for tax years 2004, 2005 and 2006. The Court entered an order 11/1/2008 for B to pay restitution to the Service. If the Service foreclosed on the lien, it could apply the proceeds to the civil tax liabilities for 2000, 2001, 2002, 2003 and 2004. As B was ordered to pay the Service restitution for 2004 (as well as 2005 and 2006), the Service may want to apply proceeds first to 2000, 2001, 2002, and 2003. Then it could apply any excess to tax year 2004. In this case, this approach would also be consistent with the Service's general policy of usually applying payments to the oldest years first. If the situation was reversed and the year(s) involved in the criminal proceeding were the older year(s), then the Service may still decide that it is in its best interest to apply the proceeds to the years that were not involved in the criminal proceeding, even though those years may be more recent.

It should be noted that the Service's lien for civil tax liabilities may not have priority. Thus, as a practical matter, the Service may not receive much of the proceeds of the collection action. Generally, the priority of the Service's lien is determined either under the rules set forth in section 6323 or by the order in which the liens attach to the property (i.e. the "first in time" rule). These priority rules are followed even when the

liens are for debts owed to different federal agencies. See, e.g., S.E.C. v. Haligiannis, ___ F. Supp. 2d ___, 2009 WL 362129 (S.D.N.Y. 2009) (lien filed by S.E.C. had priority over the Service's lien pursuant to section 6323). Because the Service usually suspends the audit of a taxpayer while a criminal investigation is underway, in most cases, the lien by the United States for the restitution order likely will be filed before the Service files a lien for the civil tax liabilities. In some cases, however, the Service may have previously filed a lien for older unpaid assessments.

Issue #4: Restitution in Excess of Civil Tax Liability

When restitution is ordered payable to the Service in a criminal case for years for which the civil tax liabilities have not yet been determined, subsequent audit or reconsideration may result in a civil tax assessment that is different than the amount ordered to be paid in restitution. In that situation, the amount of the restitution order will usually be less than the civil tax assessment and the Service will need to take collection action to collect the difference. See, e.g., Hickman v. Commissioner, 183 F.3d 535 (6th Cir. 1999). It is possible, however, that there may be instances where the amount of restitution ordered exceeds the amount of the civil tax liability subsequently determined.

The Service may determine that the amount of the civil tax liabilities is less than the amount of restitution ordered before the taxpayer fully pays the restitution. While the Code does not require the Service to notify the court of the difference, lawyers have a duty of candor to the court. Accordingly, the Service should notify the Department of Justice. As the amount of restitution ordered is generally intended to approximate the loss, the Department of Justice may decide to notify the court that entered the judgment of the actual loss to the Service and let the court modify the order as it deems appropriate. If restitution was agreed to as part of a plea agreement, however, it may not be necessary to notify the court, as the parties to a plea agreement may agree to an amount of restitution greater than the loss attributable to the offense. See 18 U.S.C. 3663(a)(3); e.g., United States v. Blake, 81 F.3d 498, 507 (4th Cir. 1996) (citations omitted); United States v. Schrimsher, 58 F.3d 608, 609 - 610 (11th Cir. 1995). The Service may still want to notify the Department of Justice to keep it informed about the case.

In cases in which the restitution was fully paid and is greater than the amount of the civil tax liability, the excess should be treated as an overpayment, because restitution is to be applied against the taxpayer's tax liability. See M.J. Wood Associates, Inc. v. Commissioner, T.C. Memo. 1998-375 ("Should it ultimately be determined that petitioners have made payments in excess of any redetermined tax liability, this Court has jurisdiction to decide the correct amount of any overpayment in the taxable years before the Court. Sec. 6512(b). That is so whether payments were made under the District Court's restitution order or for any other reason."). Generally, any tax payment that exceeds the amount rightfully due for the year is an overpayment. Accordingly, pursuant to section 6402, the Service may, within the applicable period of limitations,

credit the amount of the overpayment against any outstanding tax liability of the taxpayer, and refund any balance. See Treas. Reg. § 301.6402-1. The voluntary payment rule does not apply to overpayments, so taxpayers cannot designate how the overpayment should be applied. See I.R.C. § 6402; United States v. Ryan (In re Ryan), 64 F.3d 1516, 1524 (11th Cir. 1995) ("IRS has the discretion to designate the application of overpayments among a taxpayer's various tax liabilities"). Taxpayers must file a claim for refund with the Service in order to obtain a refund. See I.R.C. § 6511. In accordance with its procedures, after the period of limitations for refund claims expires the Service can transfer any excess funds to the general fund.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

There are no hazards or other considerations.

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